



BEFORE **THE** STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
ESTATE OF BALDWIN M. BALDWIN,) No. ' 82R-1218-MA
ET AL.)
)

Appearances:

For Appellants: J. Robert **Meserve** and
Patricia A. Jones
Attorneys at Law

For Respondent: **John A.** Stilwell
Counsel

O P I N I O N

This appeal is made pursuant to section 19061.11' of the Revenue and Taxation Code from the action of the Franchise Tax Board in **denying the** claims of Estate of Baldwin M. Baldwin for refund of personal income tax in the amount of **\$10,019.76** for the taxable year ended August 1972; of Maruja B. Hodges, nee Baldwin, for refunds of personal income tax in the amounts of **\$1,458.09** and **\$1,126.26** for the taxable years 1972 and 1973; and of George and Maruja B. Hodges for refund of

1/ Unless otherwise specified,, all section **references** are to sections of the Revenue and Taxation Code as in effect for the taxable years in issue.

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personal income ~~tax~~^{2/} in the amount of \$5,756.22 for the taxable year 1974.

This appeal involves various deductions, distributions and allocations that were either taken by the Estate of **Baldwin M. Baldwin** or made to the trusts (or beneficiaries thereof) created under the will of **Baldwin M. Baldwin**: Specifically, the issues involved in this appeal are: (1) whether it was proper **for** respondent to require a distribution of net probate income to be ratably allocated between the beneficiaries of Trust A **and Trust B**; and (2) whether a \$35,000 distribution from the Estate of Baldwin M. Baldwin, and made payable directly to appellant Maruja B. Hodges, constituted a "trapping distribution" to Trust A.

Under the terms of Baldwin M. 'Baldwin's will, several trusts were created from the residue of his estate, including the two which are the **focus of** this appeal: Trust A and Trust B. Each **trust** had separate income beneficiaries. Appellant Maruja B. Hodges is the income beneficiary of Trust A and Brian and Bruce Baldwin are the income **beneficiaries** of Trust B. .

The proper allocation between Trust A and Trust B of a court-ordered distribution of net probate income is the first issue **requiring this** board's determination. The order requiring the distribution was requested by the beneficiaries of Trust B because of their dissatisfaction with the progress being made in the administration of the estate. After due consideration, the court's final action on the petition for preliminary distribution of probate income was an order requiring an immediate \$200,000 distribution of net probate income to Trust B to be allocated equally between **its two** beneficiaries. The court also authorized a distribution of

2/ **After an extensive** audit regarding the parties' **respective** tax liabilities, certain notices of proposed assessment were revised and others withdrawn. The remainder of the assessments were affirmed, from which actions appellants filed this appeal. Appellants have paid the entire amount of the **combined** revised notices of action in order to stop the accrual of interest. W i t h respect to those items which respondent has now conceded, respondent has **indicated** it will compute the amount of any refunds due at the conclusion of this appeal.

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\$200,000 of net probate income to Trust A for its income beneficiary, Maruja B. Hodges. The timing of the distribution was left to the discretion of Maruja B. Hodges and was to be made only upon her request.

The specific language contained in the court's order is as follows:

'IT IS ORDERED:

1. That a preliminary distribution of net probate income in the amount of **\$200,000.00** be made to the Trustees of Testamentary Trust B to be allocated **\$100,000.00** to petitioner and income beneficiary BRIAN BALDWIN, and **\$100,000.00** to income beneficiary BRUCE BALDWIN to be paid forthwith by such Testamentary Trustees to said beneficiaries; that a preliminary distribution of net probate income in the amount of **\$200,000.00** be authorized for distribution to Trust A for the trust income beneficiary MARUJA BALDWIN, but that the timing of the distribution of this amount to Trust A be left to the discretion of the said MARUJA BALDWIN and be made only upon her request to the Trustees of Trust A; ... (Emphasis added.)

For the year in which the order was entered, the Estate of Baldwin M. Baldwin earned income totaling **\$166,497.06**, the entire amount of which the estate deducted as a distribution to Trust B. Respondent disallowed this allocation on the grounds that section 17762 requires the estate's distributable net income (D.N.I.) to be allocated ratably between the beneficiaries of Trust A and Trust B, with a corresponding tax liability attaching to each. On appeal, appellants **argue that** the entire amount of D.N.I. for the year was **allocable to** Trust B and, therefore, taxable only to the Trust B beneficiaries. Respondent contends that appellants' position is sustainable only if the beneficiaries of 'Trust A and Trust B are found to occupy different positions in the two-tiered statutory system providing for the ordering of income distributions. Respondent argues that it is clear that the beneficiaries of Trust A and Trust B occupy the same tier for purposes of income distributions and must therefore ratably share the **D.N.I.** available for distribution. This is true whether they

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are found to occupy either tier **one or** tier two. The tax consequences which attach to a finding that they occupy the first tier or the second tier are identical. To the extent that all distributions are to be made to beneficiaries of the same class (that is, either tier one or tier **two**), the D.N.I. must be allocated ratably among all the beneficiaries within the class.

The statutory framework for the two-tiered system of allocating **D.N.I.** between tiers of taxable priorities is found in Revenue and Taxation section 1.7762 and Internal Revenue Code section 662. In essence under both these statutes, one who has a right to current income is placed in the first tier of taxable priority and taxed on such income whether or not it is actually distributed. Section 17762 **provides** that a beneficiary shall include in gross income "[t]he amount of income for the taxable-year required to be distributed . . . , whether distributed or not" As such, **a beneficiary** cannot escape tax **liability by** refusing income which is required to be currently distributed. (Grant v. Commissioner, 174 **F.2d** 891 (5th Cir. (1949).) The decision to tax rests not on what the parties do or on the amounts actually distributed, but rather upon the right of the beneficiary to the income.

Actual payment is irrelevant in the case of a first-tier, mandatory income right. The income belongs to the beneficiaries as it arises, and it is taxed to them. **The "legal right to receive income is . . . the basis for determining the incidence of the tax."** (DeBrabant v. Commissioner, 90 **F.2d** 433, 435 (2d Cir. 1937).) The statute also provides for a second tier of beneficiaries. Under tier two all amounts "properly paid, **credited, or required to be distributed**" to the **beneficiary are includible in D.N.I.**

Because of our conclusion that the beneficiaries of Trust A and B occupied tier two, it is unnecessary to discuss whether a tier-one' distribution occurred. In order to determine whether a tier-two distribution occurred, it is necessary to determine whether the D.N.I. was properly "paid, credited, or required to be distributed" to the Trust A beneficiary, Maruja B. Hodges. Appellant argues that because the funds were **not requested there was no amount "properly paid, credited, or required, to be distributed" to her, and therefore there can be no tax due. Its offer of proof in this regard is that Trust A received no funds from the Estate that year. However, it is well settled**

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that actual payment is not required if amounts are properly credited to a beneficiary. "An amount **which** is credited . . . is included in the gross income of a beneficiary whether or not it is actually distributed." (Treas. Reg. **§ 1.662(a) (1960).**) By virtue of the court order, the Estate was required to pay \$200,000 to Trust B and to credit an equal amount to Trust A. In addition, Trust B was required to pay that amount to its beneficiaries, and Trust A was, in effect, required to credit that same amount to its beneficiary. In the absence of a showing that these amounts were not "properly" paid or credited to the beneficiaries, we must conclude that the **D.N.I.** for the year in question was properly allocated ratably between the beneficiaries of Trust A and Trust B with a corresponding tax liability to each of the beneficiaries.

The second issue requiring our resolution involves a \$35,000 distribution from Baldwin M. Baldwin's estate. In this instance, the question raised is whether Trust A or appellant Maruja B. Hodges is taxable on the \$35,000 distribution.

Appellants argue that the distribution of \$35,000 to Trust A was a "trapping distribution" taxable to Trust A. Appellants contend that a trapping distribution can, in fact, be made directly to an income beneficiary and that the mere fact that the trust was by-passed should not be the determinative factor. They also contend that to require a two-step distribution (that is, a distribution from the estate to the trust and a distribution from the trust to Mrs. Hodges) is to elevate form over substance. Appellants further observe that the trust was the income beneficiary of the estate, and, therefore, no distributions of income could properly have been made to Mrs. Hodges directly from the estate.

Respondent **concluded** that the \$35,000 distribution did not constitute a trapping distribution because the check which effectuated the distribution was made payable directly to Maruja **B. Hodges**. It argues that there was no distribution of income to Trust A which for trust accounting purposes would constitute principal, in order that the income **beneficiary** (Maruja B. Hodges) could avoid taxation on the "trapped" income distribution. Respondent, therefore, determined that Mrs. Hodges was liable for tax on **the** \$35,000 distribution to the extent of D.N.I., and Trust A **was** allowed a refund of its overpayment.

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A -"trapping 'distribution" is a distribution from *an* estate to a testamentary trust which for trust accounting purposes constitutes principal when received, but which 'for income tax **'purposes carries** out taxable income. The income taxed to the trust is referred to as "trapped income." (See generally, Bale, **302-2nd T.M., After-Death Tax Planning--Payments and Distributions**, pp. A-17-A-21, **(11/24/86).**)

Although appellants have emphasized that Haruja **Hodges** was not a beneficiary of the **Estate** and, therefore, the **Estate** could not properly distribute funds' directly to her, their reliance on this fact is misplaced. Ordinarily, there is no reason why an executor is not permitted to distribute the income of the estate directly to the income beneficiary of a trust. (**Hale**, supra, at p. A-20) In fact, Internal Revenue regulations take it for granted that the executor has the right to make payments directly to the income beneficiary of a trust. (Treas. Reg. **§ 1.664-1(a)(5)(ii)** and (iii) **(1984).**) Because the distribution was paid directly to **Mrs. Hodges**, we agree with respondent's determination that the distribution in question is not a "trapping distribution" and conclude that **it is** instead an example of a "bypassing distribution. where accumulated income is distributed directly to the income beneficiary.

'Appellants argue that **respondent has** elevated form over substance by its insistence that the fact that payment was made directly to Mrs. Hodges precludes the **finding** of a "trapping distribution." However, the literature on this subject, cited by both appellants and respondent, makes it clear that in the case of a **"trapping** distribution. there is a real distinction about how the distribution is paid, and the attendant tax consequences are, in fact, quite different depending on how and to whom the money is paid. Ultimately, who is **taxed and** 'the rate of tax are dependent on how the money is paid; (See generally, Cohan & Frimmer **"Trapping Distributions - The Trap That Pays,"** 112 Trust & Es. 766-799 (Nov. 1973): Hale, supra.)

Mrs. Hodges offers **two** final points in support of her position, **neither of** which is persuasive. First she observes that the trust **already** paid the tax on the **\$35,000** distribution: **therefore,** to subject the beneficiary to taxation on the same **\$35,000** would result in double taxation of the distribution. **However, respondent has** refunded to the trust **the tax** it paid on the **\$35,000** distribution, thereby negating any double taxation argu-

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ment. In addition, any injury to Mrs. Hodges at this time by requiring her to satisfy the outstanding liability will be mitigated when, as the income beneficiary, she shares in the refund previously paid to the trust.

Secondly, Mrs. Hodges argues that respondent is bound by the court's approval of the executrix's treatment of the distribution as a payment of principal to the trust and listed as such in **schedule 4** to the second and final account of the Estate, approved by the court on August 5, 1974. However, as respondent correctly points out, there has been no showing that the rights and interests of the respective parties have been determined in an adversarial context. Instead, a 22-page listing of actions taken by the executrix was submitted to the court for its approval and the court summarily approved the distributions. Therefore, any reliance on appellants' part that such a document is dispositive of the issue for tax purposes is misplaced.

For the reasons stated above, respondent's action will be modified in accordance with its concessions.

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O R D E R

Pursuant to the views expressed in the opinion **of the board on file** in this proceeding, and good cause appearing therefor,

IT IS HER&BY ORDERED, ADJUDGED AND DECREED, pursuant to section 19060 of the Revenue **and Taxation** Code, that the action of **the Franchise** Tax Board in denying the claims of Estate of Baldwin M. Baldwin for refund of personal income tax in the amount of **\$10,019.76** for the **taxable year August** 1972: of **Maruja B. Hodges**, nee Baldwin, for refund of personal income tax in the amounts of **\$1,458.09** and **\$1,126.26** for the taxable years 1972 and 1973; and of George and Maruja **B. Hodges** for refund of personal income tax in the amount of **\$5,756.22** for the taxable year 1974, be and the same is hereby modified in accordance **with respondent's** concessions made during the course of this appeal. In all **other respects**, **the action of** the Franchise Tax Board is sustained.

Done at Sacramento, California, this 1st day of April , 1988, by the State Board of Equalization, with Bdard Members Mr. Dronenburg, Mr. Collis-and Mr. Davies present.

Ernest J. Dronenburg, Jr. , Chairman
Conway H. Collis , Member
John Davies* , Member
_____, Member
_____, Member

*For Gray Davis, per **Government** Code section 7.9